No. 330

FILED
AUG 1 1941
CHARLES ELMORE CROPLEY
CLERK

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1941

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HYDROILOID, INCORPORATED, VERWALTUNGS UND REORGANIZATIONS A. G. SCHWYZ and HERMANN SCHERBAK,

Petitioners,

*against*

L. L. BROWN PAPER COMPANY,

Respondent,

*and*

RONALD C. LEE and JOSEPH D. LEE,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

## BRIEF FOR PETITIONERS

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## BRIEF FOR THE PETITIONERS

### I

### The Opinions of the Court Below.

1. Findings and decree of the United States District Court for the Southern District of New York, as reported in the Record submitted herewith (R. 464 et seq.), and in 32 Fed. Supp. 857, were, in part, as follows:

(a) Your petitioner, the Swiss corporation, now owns the patent (R. 514).

(b) Because of the 1930 assignment by Scherbak, the sole right of enforcing the conditions of the license is in the Lees (R. 515).

(c) Brown's right to operate under the license was confirmed (R. 514).

(d) Your petitioner was enjoined from asserting to the public that Brown is an infringer, or Brown's products may not move freely in sales in the United States (R. 515).

2. The Circuit Court of Appeals in 118 Fed. 2d 674, confirmed the above decree, and set forth its basic reasons as follows:

(a) Scherbak has no right to enforce any conditions included in the license agreement, as those obligations were given "in the nature of consideration" for the license.

So far as Scherbak is concerned, "the license must be treated as one for which the appellee (Brown) has fully paid the consideration in advance".

(b) Scherbak's only recourse against Brown would be in case of infringement.

But operation under a license, while violating conditions, though long treated by the courts as infringement, is, the decision says, no longer infringement; and cites *Motion Picture Patents Co.* v. *Universal Film Co.*, 243 U. S. 502, as authority.

## II

## Jurisdiction.

1. Statutory provisions believed to sustain the jurisdiction of this Court are Secs. 237, 240, Act of February 13, 1925; Declaratory Judgment Act, Art. 274d, 28 U. S. C. A. Art. 400; Patent Laws of the United States.

2. Decision of the Circuit Court of Appeals of the Second Circuit, review of which is sought, was entered at a Stated Term on the 2nd day of May, 1941; reported, 118 F. 2d 674.

## III

## Statement of the Case.

1. The attention of the Court is respectfully directed to the petition herein, which contains a general outline of the facts, and which, in the interest of brevity, will not be repeated here. Additional pertinent facts are included hereunder. Unless otherwise indicated the name, "Scherbak", will be used to indicate all the petitioners herein.

2. Respondent L. L. Brown Paper Company is a Massachusetts corporation, and holds the limited patent license here involved.

3. Respondents Ronald C. Lee and Joseph D. Lee, an attorney, resident in New York, formerly president and general manager, respectively, of Hydroiloid, Incorporated, in association with petitioner Hermann Scherbak, are now the assignees holding all Scherbak's interest in the Brown license. They will be referred to as "the Lees"; or, if referred to individually, as "R. C. Lee" and "J. D. Lee", respectively.

4. The subject matter is a valuable patent, United States Letters Patent No. 1,682,390, issued August 28, 1928, which gives new and important qualities to paper. Prior to the issuance of letters patent this invention was owned by an European company, herein referred to as the Parent Company, which was directed and controlled by petitioner Hermann Scherbak.

5. In 1921 Scherbak and the Lees organized a New York corporation, Hydroiloid, Incorporated, to develop the process in the United States; and the Parent Company, through Scherbak, transferred ownership of the invention or process, with certain applications thereon for letters patent in the United States, to the said Hydroiloid, Incorporated. R. C. Lee was made president; and, prior to most of the events

here involved, J. D. Lee became trustee for the Parent Company to receive and transmit to them their separate share of royalties as they were received by Hydroiloid, Incorporated (R. 80, 143). Scherbak, meanwhile, returned to Europe, leaving affairs in the hands of the Lees; though with some corporate restriction on their authority for independent action (R. 308, 310).

6. There was delay in getting effective licenses placed, and in 1925, shortly prior to November 9, 1925, when the Brown license was issued (R. 16), the New York Company needed extra funds and expert help beyond what Scherbak had agreed to furnish. Such funds and services were furnished by Scherbak, on agreement by the New York company signed by R. C. Lee, that 75 percent of all "money or other value" received, during the life of such licenses as were secured within a specified time, should be paid to the Parent Company under an "irrevocable assignment" (R. 106, 80). The Brown license came under that assignment.

**The Lees Tortiously Acquire License Rights.**

7. In 1927 the Lees attempted to induce Scherbak to relinquish his right to 75 percent of the value collected from Brown's license. Scherbak refused, and left for Europe. During his absence J. D. Lee, the lawyer, resigned as Scherbak's trustee, and guided the company through a tortious assignment and sale of assets "for the benefit of creditors", duly confirmed by the New York Court (R. 329, 331, 335, 336, 339, 363, 365), though no facts were shown indicating necessity therefor save to eliminate Scherbak. Liabilities were grossly exaggerated (R. 169). Assets, including the process and Brown's license, with $4,000 a year minimum royalty, were sold to R. S. Lee for $100.

8. Partial restitution was secured to Scherbak, as recounted in the petition. Lee accounted for $9,000 of royalties received from Brown, and this he was allowed to retain.

Scherbak received a right to proceed against Brown for an accounting; a right he never pursued, as he learned but recently of then existing defaults as specified later. In turn, Lee assigned to Loeb, who took for Scherbak, shares of stock owned by the Lees in Hydroiloid, Incorporated, also title to the patent and the "Hydroiloid" trademark (Ex. 29, R. 381); R. C. Lee's purpose being to give up "everything he owned in the patent to the assignee" (R. 167). Those same assets were conveyed by Loeb to the Parent Company on, January 19, 1931 (R. 448); and by them, on or about May 3, 1935, to the Swiss Company, the present owner (R. 450). Lee caused the patent to be issued to him, and after some controversy induced Brown to pay accruing royalties to him. Brown knew of the assignment to Scherbak (R. 185), and required Lee to furnish indemnity bond (R. 187, 127).

9. Two unexplained and striking examples of beneficence towards Brown have been performed at the hands of R. C. Lee and Carrol S. Loeb, respectively. Shortly after Lee had transferred the patent to Loeb, he granted to Brown a very substantial reduction in royalties; both minimum requirement and rate per pound (R. 156, 157). Loeb, on May 24, 1933, indulged in a similar act of generosity. He released to Brown, for a cash payment of $875, all future claim on royalties from Brown, though these were obligated to him at the rate of $2,000 every year, (R. 188, 413, 414). By transfers between themselves, R. C. Lee made J. D. Lee owner of a half interest in the license contract rights acquired in the manner just related.

**The Brown License and Violation Thereof.**

10. Brown's license contract contains a number of covenants imposed to limit his authority of user, and thus define and benefit the patent owner's reserved interest in the patent. Though some are stated in language such as "The licensee agrees that the process shall be disclosed only to"

particular persons (R. 17) their relation to the ungranted patent interest seems clear. The grant, as amended, is an exclusive license for use on rag content paper, and to "use and sell such paper in the United States".

11. There are a number of such important limiting covenants of the licensee besides those in controversy here, a full list of which is given below. Any or all of them can be breached with impunity under the present decision, and the patent owner has been made helpless to protect his patent from injury or sabotage by Brown.

12. The limitations chiefly involved are the following: all improvements in process accrue to the "proprietor and inventor", subject to Brown's right of user (R. 18); and Scherbak's trade name must be used in connection with sale of the product, though not excluding joint use of some other name.

13. An important improvement in the process was developed between 1927 and 1929, and put into use by Brown under the trade name "Resistall" which their catalogues described as a process exclusively their own, and developed by them (R. 220). The product was admittedly indistinguishable from Hydroiloid processed papers (R. 212, 213). The District Court spoke of this process as an "improvement" (R. 504); and if so, the right thereto had accrued to Hydroiloid, Incorporated, prior to the assignment of the license contract, and prior to November 5, 1930, hence prior to Scherbak's relinquishment of his right under assignment to 75 percent of all "value" received from Brown.

14. Brown also ceased to use the trademark "Hydroil" or "Hydroiloid" in connection with the sale of papers marketed as "Resistall"; though Brown's president, A. M. Daniels, admitted that by their "exclusive, protected process" was meant "Hydroiloid plus improvements" (R. 211). J. D. Lee, beneficent friend towards Brown, and tortious

trickster towards Scherbak, testified that he had orally authorized the change, but admitted having no correspondence or any other writing whatever evidencing or even referring to such "permission" (R. 151). The trial court, however, accepted this testimony as true.

**Scherbak's Lack of Knowledge.**

15. Scherbak's first information about the existence of this name "Resistall", in connection with products of the Hydroiloid process, occurred in 1929, in Europe, when he saw some samples with that name written on them by hand. Inquiry as to the matter (R. 410) elicited a reassuring reply from Brown (R. 412), saying in effect that they were not responsible for the presence of the samples in Europe, and someone else must have sent them over. There was no disclosure as to the substitution by them of "Resistall" for "Hydroiloid", nor intimation that they had developed an important improvement.

16. In 1935 Scherbak, then in the United States, learned that papers of Hydroiloid type were being offered as "Resistall". He wrote Brown (R. 415), and received a reply (R. 417) denying his right to question Brown. It was not until December, 1937, or January, 1938, that he actually saw one of Brown's catalogues; and therefrom learned that "Resistall" was being sold as the distinct and superior product of an exclusive process allegedly discovered by Brown (R. 248, 249). That, he testified, was his first knowledge of the nature and extent of this breach of condition.

17. Accordingly, on May 12, 1938 (R. 419) he wrote notifying Brown to "cease and desist" any use of the patent. On May 14, 1938 (R. 420) he served Brown with notice of license termination, as of June 8, 1938, on the ground of violation of its terms.

**The License Contract.**

18. The license contract itself (R. 16), as modified (R. 23), is summarized by the trial court and included among the findings of fact (R. 498). This summary is as follows:

> "By a license contract dated November 9, 1925 and amended by a written instrument dated April 29, 1926, the respondent Hydroiloid, Incorporated (called therein the Proprietor) granted to the petitioner (called therein the Licensee) the exclusive right to use said process in the United States for the treatment of any and all rag content writing paper in the United States, in consideration for which the petitioner (Licensee) agreed to observe or perform certain terms and conditions, inter alia, to wit, (a) to pay Hydroiloid, Incorporated, royalties at the rate of Twenty Dollars ($20) per ton of paper processed, with a minimum quarterly guarantee of Fifteen Hundred Dollars ($1500) beginning with the second year of said license contract; (b) to keep records showing the amount and kind of paper which it treated by said process; (c) that all paper and other products so treated by it must be sold under trade names which should include the words "Hydroil" or "Hydroiloid" as a part; (d) to exchange with Hydroiloid Incorporated samples and testimonials; (e) to make no unauthorized use of said process or assist others in so doing; (f) not to use any competitive process while retaining its said license; (g) to keep said process strictly secret and to obtain from all those to whom it might be necessary to disclose said process a like agreement (1) to keep it secret (2) to make no unauthorized use of it and (3) to deliver all improvements made by them to the petitioner (Licensee); and (h) that any improvements made by the petitioner (Licensee) should become the exclusive property of Hydroiloid Incorporated for all other uses than those within the field of its said license."

19. Reference to the actual text of the above-summarized contract (R. 16), discloses no words or language in support of the concept, evidenced in the above summary, that the terms and conditions therein were promises given "in consideration for" the license. Instead, after stating that the Proprietor has a special process, and the Licensee desires to attain certain results in its paper, it continues simply: "Now, therefore, the parties herein agree as follows:".

20. Thereafter, in the license contract, come provisions set forth by titles: "Guaranties"; "Consulting Service"; "Patents"; "Territory and Uses"; "Payments"; "Sublicenses"; "Termination"; "Infringement". Under these are set forth the various conditions imposed by Scherbak as limits on the rights of use he was granting.

21. It is perfectly possible to regard those conditions as an effort by the licensor to define the magnitude of the right of user bestowed on the licensee. Under that concept, rights under the license were conditioned on a process and patent use under conditions whereby (a) reasonable precaution would be exercised to prevent disclosure; (b) there should be no challenge of licensor's right to the process or patent; (c) improvements made in the process become licensor's property, subject to this license; (d) certain qualities of paper may be processed, but no others; (e) competitive processes may not be used; (f) licensor's tradename, 'Hydroil" or "Hydroiloid" shall be used to identify the product when offered for sale; (g) user shall not be assigned; (h) sales shall be limited to the United States; and (i) unauthorized use shall entitle the licensor to terminate the license.

**The Action and Appeal Below.**

22. Brown thereupon, on the 21st day of June, 1938, commenced this action in the District Court of the United States for the Southern District of New York, under the

Declaratory Judgment Act (Judicial Code, Sec. 274d; 28 U. S. C. A. Sec. 400); and petitioned, among other things, for adjudication: (a) confirming their rights to the license, and (b) enjoining your petitioner from interfering with the exercise thereof (R. 14-15).

23. Your petitioner counterclaimed, among other things (R. 50) for adjudication that (a) the Swiss Company owns the patent and trademark "Hydroiloid"; (b) the Lees have no interest in the license other than in royalties therefrom; (c) Brown breached the license and Scherbak may cancel the license pursuant to its terms; (d) termination thereof occurred on June 8, 1938, and subsequent use of the patent by Brown was an infringement.

24. For the present purposes, the counterclaims of the Lees are immaterial, save one, viz. that your petitioners have no rights whatever in the license contract.

25. Under the decree below, and decision of the Circuit Court of Appeals, as stated in the Petition, your petitioners' claims were all denied, save the one as to ownership of the patent.

## Specification of Errors to Be Urged.

The Circuit Court of Appeals for the Second Circuit erred:

1. In deciding property rights under the patent law, rather than under local property and contract law, when those rights took form in connection with a secret process, for which the patent did not issue until after rights had become vested as between the process owner and his licensee.

2. In applying federal or patent law in determining the property rights in a patent, as between licensor and licensee, as to relationships antedating the patent.

3. In deciding, as a matter of law, that conditions imposed in licensing the partial use of a secret process are obligations assumed in consideration of the license, rather than limitations imposed on the quantum of the licensor's grant.

4. In granting equitable remedies to a petitioner in default on the very contract sought to be confirmed; and whose claim amounts, in part, to assertion of release from important obligations, where the claimant is at most but an incidental beneficiary under a contract between other parties, in regard thereto.

5. In deciding, as a matter of law, and in disregard of established precedent, that operation under a license, while violating lawful license conditions, is not an infringement.

## Summary of Argument.

The Declaratory Judgment decree below (which deprived your petitioner of all benefit of licensee obligations under a partial license, reserved for the benefit of the ungranted patent interest) has reached that result only by: (a) ignoring or refusing to apply local property and contract law which would otherwise preserve those rights; and (b) distorting a decision of this court to deny your petitioner his federal law rights as against an infringement.

Despite the unquestioned applicability of local law to determine property rights, whether in a patent or in any other personal or real property, subject only to federal law when it properly intervenes, your petitioner has been denied the benefit thereof. That denial did not occur through an express consideration of these laws; but rather by ignoring their existence and their effects, in formulating the judgment below.

Your petitioner owns the ungranted or unlicensed rights to this patent, which he received by assignment from one Lee; who had title not only to the patent, but also to a license contract with Brown, and retained the license contract for himself. The license contract, issued on a secret process before letters patent had been granted thereon, was limited by special conditions of great importance, but intended mainly or entirely to benefit the retained or reserved interest of the process owner. One or more of these important conditions are now breached; and the judgment below denies the patent owner any remedy whatever therefor.

Under New York law the facts of this case entitle any property owner to a variety of remedies. In the first place, Brown would be barred by equity because in default on the contract they ask equity to confirm. Brown would be barred of remedy, as to obligations enforceable by no one, if not by your petitioner, because then they would be asserting a right under a contract with relation to which they are, at most, mere incidental beneficiaries.

Substantive rights accruing to your petitioner, under local law, include the property owner's right to a remedy against one who uses his property, but can show no authority for using it under the conditions obtaining. The license does not *create* rights for the property *owner;* it merely *grants away* rights which are measured by all the conditions then imposed. Use in breach of those conditions, therefore, is unauthorized by the license. Such is local law as to property, the use of which is licensed to another under conditions stated.

Even if technical rules of law should defeat the above rights of a property owner, equity stands ready, under local law, to step in and declare an equitable servitude in behalf of the owner of property, whether personal or real. The purpose of local law is to afford a remedy for breach of property rights, and both law and equity are available, in a case like this, when contractual obligations do not run as between the parties.

If these state law property rights did vest (as vest they undoubtedly did, back in 1925), they have continued in effect since that time unless the granting of letters patent in 1928 brought about a change as a matter of law. If it did produce a change, as is necessary to give support to the decision we ask to have reviewed, then this is new general law of great importance. It should be determined by the Supreme Court for the country at large.

We do not deny that language in a license contract might indicate that positive promises by the licensee were consideration for the license. That situation probably applies in most cases, so far as clauses relating to royalty are concerned. But it is, we contend, utterly untrue that, as a mere matter of law, clauses inserted for the protection of the *res* are in that category. Indeed, the opposite presumptions are so strong that unequivocable intent would seem needful to overcome them.

In deciding, as a matter of law, that, breach of lawful conditions imposed on use is not infringement, the Circuit

Court of Appeals has no support in decided cases or in reason. The authority cited—*Motion Picture Patents Co.* v. *Universal Film,* 243 U. S. 502—merely denies the right of a patentee to use conditions to monopolize unpatented materials. It limits, but does not purport to destroy, the effectiveness of conditions. So isolated an opinion cannot, in your petitioner's opinion, safely be left unchallenged and untested. If neither affirmed nor reversed, it tends to shake the confidence of lawyers and laymen in the unity and quality of our law.

## ARGUMENT

### POINT I

**When local property and contract law establish certain enforceable rights as between the owner of a secret process and his licensee, those rights may not be ignored by a Federal Court merely because letters patent are meanwhile issued.**

The Declaratory Judgment decreed by the courts below, if not reversed and remanded for error, denies to your petitioners the protection of local property law; and in effect punishes your petitioners, who own the patent under assignment, for attempting to cancel Brown's license contract for breach of condition. And their only reason given therefor is the retention of the license contract by Lee, when Lee assigned the patent to your petitioners.

In that judgment it was decreed that respondent-licensee Brown is no longer required to perform any of the express provisions of the license which are for the benefit of the patent owner; and accordingly is allowed:

> A. To keep for himself all title and information about the nature of improvements in the process which

by the terms of the license are the property of the patent owner;

B. To suppress the trade-name "Hydroiloid" when selling the products, and substitute their own brand, "Resistall", in breach of the conditions of the license; thereby depriving your petitioners of the advertising value thereof and misleading consumers as to the use of petitioner's patent;

C. To breach any of the other conditions imposed in the patent license for the patent owner's protection, as to which your petitioner is denied any rights of enforcement whatever. See Par. 21, Statement of the Facts.

### 1. Issues Involved.

Your petitioners contend that this case hinges, in the last analysis, on one or both of two main issues. Taking up the first, the right of Brown to evade its obligation to the patent owner depends on the nature of property rights that vested under state law as between the licensor and licensee of a simple secret process. The decision of the court below is possible only because it completely disregards those rights. This brings that decision sharply into conflict with the theory and practice of concurrent state and federal jurisdiction over matters arising under state law.

The principle is well settled that federal courts, when dealing with litigants whose rights grow out of circumstances not within the exercised scope of federal control, shall apply, as scrupulously as circumstances permit, the law of the State as it has been determined by State courts[1], so long as no provisions of the United States Constitution are offended thereby[2]. Indeed the acceptance of this principle as a guide in ordinary cases is virtually unquestioned.

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[1] *Kuhn* v. *Fairmont Coal Co.*, 215 U. S. 349, 30 S. Ct. 140.
[2] *Muhlker* v. *N. Y. etc. Ry.*, 197 U. S. 544, 25 S. Ct. 522.

It has long been settled that a dispute does not arise under the patent laws where one party "admits the validity and his use of plaintiff's letters patent, and a subsisting contract is shown governing the rights of the parties in the use of the invention"[3]. Suit for specific performance of a license contract is not of itself within federal court jurisdiction[4]. In New York the same rule has been applied, holding that an action which requires only the determination of rights resulting from a patent license, "involved the consideration of no question arising under any act of Congress in relation to patents. And in that view the case was properly in the state court for determination."[5]

This leads us to inquire how so prevalent a proposition came to be overlooked in the court. It is certainly not entirely the fault of your petitioner's counsel in that case, as he presented three New York cases which determined the vital point at issue in a manner directly contrary to the decision below[6]. The *Huerstel* case concerned a lease of real estate, rather than the lease of a secret process, but it clearly enunciated the rule, as contended for vainly before the Circuit Court of Appeals, that the assignment of a lease, however broad the terms, conveys nothing to the assignee except the right to collect rent, and such other rights as are incident thereto. The decision below ignores those cases and proceeds on an independent analysis depending but little on cited cases, and much on legal doctrines not related to the real issues. In that decision are cited but five decisions, all by United States courts, and none of these even hint that local law does not determine respective rights under the license document. These will be discussed under Point II.

It might be that the involvement of letters patent nevertheless distracted the attention of the court. If it did, that

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[3] *Hartell* v. *Tilghman*, 99 U. S. 547. The rule of this case has been followed by federal and local courts in all parts of the country.

[4] *Indiana Mfg. Co.* v. *Shepard Co.*, 190 Fed. 579.

[5] *Mayer* v. *Hardy*, 127 N. Y. 125, 130.

[6] *Huerstel* v. *Lorillard*, 6 Rob. 260, 262 (N. Y.); *Demerest* v. *Millard*, 8 Cow. 206 (N. Y.); *Kelly* v. *Smith*, 16 N. Y. Supp. 521 (not officially reported).

diversion of attention was not blamable entirely on the trial judge, for he said in discussing the assignability of patents: "The right to make, use or vend an invention is a common law right and a patent confers the right to exclude others". Clearly, if a common law right, as it undoubtedly is, it must be determined by the local law, in so far as not in conflict with the patent law itself.

**2. This Case Originated in a License to Use a Common Law Property Right; and State Law Provided Remedies based on Property Law rather than the License Contract.**

Even the foregoing conclusion could be untrue, however, without putting this case under federal law. Here there was no patent when the parties became licensor and licensee in 1925. The rights at that time were unquestionably common law rights, in no way involved with patent law. They continued as common law rights, at least until August 28, 1928, when the patent was granted. Is there any rule of patent law which at that moment upset these old relationships and created new ones? Your petitioner is aware of none. And even if there were, it would not be retroactive. In the absence of statutory mandate, clearly enunciated court decisions, or some compelling public policy, it is difficult to perceive any valid reason why the mere granting of a patent should alter the effects of lawful contract after it had become operative on the parties under local law.

Under New York law the legal effect of an assignment of a lease is limited. It conveys a right to collect royalties and to enforce their payment, and no more[7]. The intent of the parties to a contract controls its interpretation, rather than the broad and literal meaning of language used[8]. The

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[7] See note 6, *supra*.

[8] *Hoffman & Place* v. *Aetna Ins. Co.*, 32 N. Y. 405; *White* v. *Hoyt*, 73 N. Y. 505; *Gumbinsky Bros. Co.* v. *Smalley*, 203 A. D. 661, 197 N. Y. Supp. 530; a.w.o. 235 N. Y. 619.

use of personal property in violation of conditions imposed is an unauthorized use of property, and Scherbak would be entitled to reclaim it, or elect among a variety of other available legal and equitable remedies[9] for use under conditions not authorized. If otherwise inadequately protected against non-performance by Brown of obligations intended to benefit his ungranted interest in the patent, then Scherbak would have open to him the protection afforded by an equitable servitude[10].

Moreover, under state law, Brown would have no standing whatever in court, in contending that the Lee-Scherbak contract released him from obligations to Scherbak; after it became evident that some of those obligations could be enforced by no one at all, if not by the owner of the patent. In claiming release of that kind he is merely, at most, an incidental beneficiary of an assignment to which he was not a party. Such incidental beneficiaries have no claims growing out of the contract[11]. Brown might ask the court to declare the party to whom performance might be owed, but not for a decree that turns the third party contract into a release as to some of his material and important obligations. As to those, his petition could not be lawfully granted under state law.

That your petitioners are entitled to the benefit of all these property rights, as distinguished from contract rights, through their ownership of the patent, is clearly indicated by the language of Chase, J., in the judgment below. He

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[9] *Doyle* v. *Chatham Bank* 253 N. Y. 369, 171 N. E. 574; *Col. & S. Ry. Co.* v. *Blair*, 214 N. Y. 497, 108 N. E. 840; Am. Juris. Sec. 235, and cases cited; *Bush* v. *Fourcher*, 3 Ga. Ap. 43, 59 S. E. 459; *La Plante* v. *Du Pont*, 223 Mich. 343, 193 N. W. 820; *Empire Refineries* v. *Guaranty Trust*, 273 Fed. 668 (C. C. A. 8th).

[10] *Evans* v. *Foss*, 194 Mass. 513, 80 N. E. 587; *Barrow* v. *Richard*, 8 Paige 351; *Lewis* v. *Gollner*, 129 N. Y. 227, 29 N. E. 81; *Murphy* v. *Christian etc. Co.*, 38 A. D. 426; 56 N. Y. Supp. 597; *Francisco* v. *Smith*, 143 N. Y. 488; *Palumbo* v. *Piccioni*, 89 N. J. Eq. 40, 103 A. 815.

[11] *Restatement of Contracts*, sec. 133, illus. 5; *Sherman* v. *Abeles*, 265 N. Y. 383, 95 A. L. R. 1384; *Morgan* v. *Elco Mach. Co.*, 293 A. D. 346, 267 N. Y. Supp. 369.

said: "What Scherbak received on the assignment of the patent by Lee could not, of course, exceed Lee's interest and so Scherbak took the usual rights of a patent owner diminished by appellee's (Brown's) right to use the process within the scope of the license".

What the judgment below fails to do, however, is to recognize that the limits on "appellee's right to use the process" are themselves determined by local property and contract law; and by that law a breach of license condition is enforceable by the owner of property, regardless of privity of contract. In short, under local law, the person using another's property has no authority except the terms and conditions of his license. Use in violation of those conditions is unauthorized use. And if, by reason of transfers of title to the property, the owner is unable to enforce his rights at law, then equity will do so under the doctrine of *equitable servitudes.*

### 3. License Conditions Merely Define the Circumstances Under Which Property May be Used by Another Without Liability Under Common Law Property Rights.

In argument before the Circuit Court of Appeals, perhaps the most persuasive point made by Brown's attorneys was one based on general law, as distinct from patent law. This point was stated as follows: "Lee, having title to both the license contract and the patent and having assigned the patent only, retaining all interests in the contract, the assignee of the patent acquired no interest in the contract and, hence, has no rights to enforce it".

This principle, however, if valid as it relates to the assignment, must likewise be valid in relation to the original license. As applied to that license, then, it should be stated thus:

> "Hydroiloid, having title to the secret process, and having given Brown a license under certain conditions

and limitations, retaining to itself all rights not definitely conveyed under those limitations, conveyed no right to operate in violation of those conditions. Accordingly operation in breach of those conditions was unauthorized use of Hydroiloid's process."[12]

The case below clearly established the complete nonperformance of one very important license condition, and apparently of two. In the original license granted from Hydroiloid to Brown, is the following provision as to improvements in the secret process:

> "Improvements made by either party in the process or such improvements as may come into their possession, may be used by the Licensee to the extent of its license, specified below. For any other uses, they are the exclusive property of the proprietor and the Inventor" (Ex. 1, R. 18).

This provision must, of course, be construed, if possible, to have a meaning and a legal effect. To give it such meaning and legal effect it is necessary to construe the last four words to mean "the owner of the process, and successors thereof". Otherwise, we would have the anomaly of possibly attempting to separate ownership of improvements from ownership of the property, and to vest the improvements in persons unable to use them for lack of right in the process to which they pertain. We accordingly contend, without much fear of disbelief, that ownership of the

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[12] In the *Chatham Bank* case, cited in Note 9, *supra*, a corporate bond indenture was innocently breached by action unauthorized by its terms; with serious loss to the bondholders. Bondholder suit for damages was upheld, because the defendant had no authority over the intangible securities involved save that specifically conferred. In *La Plante* v. *Du Pont*, and in *Bush* v. *Fourcher* (note 9, *supra*), profits from unauthorized use were held to belong to the owner. In the *Empire Refineries* case (note 9) the contractual rate of compensation was disregarded, as to unauthorized use, for which the owner collected at a much higher rate than applied to authorized use.

improvements attaches to ownership of the process; so that ownership of one includes ownership of the other. Any other construction defeats the operation of this provision.

The facts clearly show, and the trial court found (Ap., R. 504) that no disclosure of the highly valuable "Resistall" improvements was ever made to Scherbak. It is there held, however, that the right to them passed to Lee by virtue of his $100 purchase of Hydroiloid assets, under "assignment for benefit of creditors" process, in 1928; and remained with him after the assignment of the patent to Scherbak in 1930; the grounds apparently being that Scherbak received no interest in the contract and can therefore enforce no rights created under it.

Under New York law, however, Scherbak received all the property rights that Lee had in the patent; and these included the right to prevent Brown, or any one else, from using the patent save under conditions imposed in the license for the benefit of ungranted and retained patent rights. The importance of this "Resistall" is said to be great. The claims for it hinder Scherbak in developing his own reserved patent rights. He was told by Brown, repeatedly, that they recognize no rights by Scherbak as to any of the conditions set forth in that contract.

There was also another serious breach of condition, which relates to the use of Scherbak's trade-name "Hydroiloid" when selling the product. The use of this trade-name was of great importance to further development of ungranted patent rights; and its suppression has created great injury to the patent owner. The trial court held, to be sure, that Lee had orally authorized the suppression of that name; but that would not seem binding on an assignee of the patent who had no notice thereof.[13]

Their use of the patent, therefore, while thus denying to Scherbak the rights reserved, as owner, is an unauthor-

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[13] *Gates Iron Works* v. *Fraser*, 153 U. S. 332.
*Faulkner* v. *Empire State Co.*, 67 Fed. 913 (C. C. A. 2nd).

ized use. He has remedies therefor under state law, which the judgment below has denied. The mere fact of long continued use in violation of authority creates no defense.[14] There has thus been an important breach of condition; a breach which deprives Brown's use of the patent of its authorization by and protection from the license; a breach which leaves Brown in the position of one who appropriates the property of another without authorization from the owner. For those the state law provides a variety of important remedies.

In short, Brown's obligations to the owner of the patent are not created by the license. On the contrary, the license merely created rights in Brown to use another's property under certain conditions. Any and all use not in accord with the license is a trespass on the property right of an owner. The property owner may restrain any and all use of his property, except in so far as the user of the property can show authorization. The patent license did not authorize any use at all, save under conditions which include the two mentioned here. Breach of conditions, under local law, is thus an offense against property right; and for this the owner has a variety of remedies, as previously stated.

### 4. Decision Below Ignores Provisions of State Law for Protection of Property from Unauthorized Use, and Wrongfully Treats the Assignment of Contract Rights Only as an Assignment of Common Law Rights in Property.

The Circuit Court of Appeals, in the decision below, made no reference whatever to local law applicable to property. It speaks of contract rights, and the effect of their assignment to others. But it completely ignores state decisions applicable for the protection of property as

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[14] *Dunn* v. *Turner*, 219 F. 188; 135 C. C. A. 74 (Minn.).
*Smith Hdwe. Co.* v. *Pomeroy Co.*, 299 Fed. 544 (C. C. A. 2nd), cert. den. 265 U. S. 592.

against one who uses it in a manner, or under conditions, for which he has no authority from the present or any past owner.

There seems no doubt that an assignment of a contract transfers all that the assignor is lawfully able to pass to the assignee. If portions of the contract are not assignable, provisions for the collection of money thereunder may nevertheless pass; and the others remain with the main obligee. This rule has applied to contracts involving such unassignable matters as personal obligation;[14a] it has governed the assignment of a lease on land, which was held to convey none of the rights of a landlord, "except merely to (maintain) action to recover the rent". In an early New York case the court held that right to collect rent passes with a deed to the reversion of property, unless reserved: but the assignment of a lease carries with it no interest in the land, and no right in damages for breach of other covenants in the lease[14b].

As to the effect of granting a patent, after those common law rights had accrued, there is nothing in cases cited by the Circuit Court of Appeals or by Brown's attorneys in their brief before that court, to indicate the slightest effect of a patent in limiting or changing the common law rights otherwise applying to patent owners in dealing with their property right in patents. In discussion of the issues involved, *supra*, it was clearly shown that patent law is not involved in determining rights of the kind here involved.[15] Rights in property, leased to a licensee under special

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[14a] *In re Wright*, 157 Fed. 544, 546 (C. C. A. 2);
*Sharp* v. *Farb*, 3 Sandfords 379, 383 (5 N. Y. Super. Ct.);
*Fortunato* v. *Patten*, 147 N. Y. 277;
*Gray Engine Starter Co.* v. *Gray & Davis, Inc.*, 224 F. 723 (D. C. Mass.).

[14b] *Demerest* v. *Willard*, 8 Cowan. 206 (N. Y.);
*Huerstel* v. *Lorillard*, 6 Rob. 260, 262 (N. Y.).

[15] In addition to cases under notes 3 and 4, *supra*, see: *Odell* v. *Farnsworth Co.*, 250 U. S. 501, 503; *Pratt* v. *Gas Co.*, 168 U. S. 255, 259.

covenants afterwards breached, were fully upheld in a recent case by the Circuit Court of Appeals of the Fourth Circuit.[16] It rests with the owner of a patent to say what part of his property he will reserve to himself and upon what terms a third person may use that property.[17]

The decision below has plainly disregarded a primary tenet of federal court obligation with respect to state law. It has ignored state law applicable to the subject matter. It has cited no federal statutes, no constitutional provisions, no implied or express mandate in decided cases, compelling it to substitute its own views of contract as against the state law of property. Even the *Universal Film case*,[18] however accurately and correctly applied in the case below, would not affect or impair Scherbak's property rights under local law. If that case means what the Circuit Court of Appeals says it means, it might prevent maintenance by Scherbak of a suit for patent infringement. But how could it bar an action under local law for unauthorized use of the patent property?

**5. Under Universal Equitable Principles, that Claimants of Equitable Aid Must Themselves "Do Equity" and "Come With Clean Hands", the Petitioner Below Should Have Been Barred From Access to a Court of Equity.**

The unquestioned applicable rule of equity, as stated in American Law Reports (4 A. L. R., p. 73n) is as follows:

> "A party to a contract who fails to perform a material obligation of the contract is not in court with 'clean hands' when he seeks the aid of a court of equity

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[16] *M. J. Carroll* v. *Gilmore*, 103 F. 2d 560 (C. C. A. 4th).

[17] *National Phonograph Co.* v. *Schlegel*, 128 Fed. 733 (C. C. A.). *Bement* v. *National Harrow Co.*, 186 U. S. 70.

[18] 243 U. S. 502.

in the protection of his alleged rights arising out of or connected with the contract, and *is not entitled to the relief prayed.*"[19]

In the case below, Brown was in default on the very contract which equity was asked to confirm for Brown's benefit. Equity does not recognize a petitioner who asks aid while hiding behind technical rules of law.

In thus disregarding well known principles requiring federal courts to recognize and apply local law in cases like this, and in ignoring and refusing to apply local law, the Circuit Court of Appeals of the Second Circuit has so far departed from the accepted and usual course of judicial proceedings as to call for supervision by the Supreme Court; or it has determined an important question of federal law which has not been, but should be, settled by the United States Supreme Court; or it has perhaps inadvertently but none the less truly decided an important question of local law in a way most definitely in conflict with applicable local decisions. In any case the decision is one which your petitioner contends should not be, ought not to be, left to upset and disturb court decisions throughout the nation.

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[19] *Ashe-Carson Co.* v. *Bonifay* (1906), 147 Ala. 376, 41 So. 816.
*Newly* v. *Lawrence* (1909), 84 Neb. 622, 121 N. W. 967.
*Georgia Bldg. Co.* v. *Burdett* (1914), 150 N. Y. Supp. 27.
*Hardee* v. *Alexander* (1915), Tex. Civ. App. 182 S. W. 57.
*McGinnis* v. *Knickerbocker Ice Co.* (1901), 112 Wis. 385, 88 N. W. 300; 69 L. R. A. 833.
*Montana Water Co.* v. *Billings* (1914), 214 Fed. 121. Appeal dismissed by C. C. A. 224 Fed. 1021.
See also:
*Gibson* v. *Kansas City Refining Company*, 32 F. 2d 658.

## POINT II

**In holding that breaches of condition as to use of a patent are no longer infringements the Circuit Court of Appeals of the Second Circuit is in conflict with opinion in the Seventh Circuit and apparently in conflict with the Supreme Court itself.**

On this point, we are concerned with a proper application of the *Universal Film Co. case*[1]. If that case clearly means what the Circuit Court of Appeals of the Second Circuit says it means[2], in deciding the case below; and if the contrary interpretation by the Circuit Court of Appeals of the Seventh Circuit, under somewhat different facts[3], is of little legal moment, then your petitioners' case will rest entirely on the cogency of Point I. Otherwise this point, also, should entitle us to prevail here.

Examination of the case leaves one's mind somewhat bewildered that so eminent a court could have given it the interpretation made in the decision which your petitioner prays to have reviewed. Under commonly accepted rules of interpretation the effect of the Supreme Court decision is limited to the issues under discussion, and those did not involve the effect, either way, of a breach of the general conditions in a patent license agreement. In the *Universal Film* case the issues were clearly limited. They related only to conditions intended to extend the monopoly of a

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[1] *Motion Picture Patents Co.* v. *Universal Film Co.*, 243 U. S. 502.

[2] "It is now well settled contrary to what had formerly been held in *Heaton-Peninsular Button-Fastener Co.* v. *Eureka Specialty* Co., 77 Fed. 288; *Indiana Mfg. Co.* v. *Shepard Co.*, 190 Fed. 579 and *Henry* v. *A. B. Dick Co.*, 224 U. S. 1, that the breach by a licensee of an obligation in a patent license to perform as to a subject not within the claims of the patent itself is not an infringement of the patent. *Motion Picture Patents Co.* v. *Universal Film Co.*, 243 U. S. 502."

[3] *American Lecithin Co.* v. *Warfield Co.*, 105 Fed. 2d 207, 211.

patent to include materials on which a patent had expired[4]. The parties defendant were not licensees. Instead, they were a corporation which had leased patented equipment from one who had bought it from the patentee.

### 1. Interpretation by Text Writers is Opposed to that by the Circuit Court of Appeals of the Second Circuit.

While of course your petitioners recognize that interpretation of a decision by non-judicial writers is not binding on any court, it is nevertheless helpful to ascertain what such interpretation has been. The very reporter of the decision, in preparing head notes for it, seems to have understood it as applying only to conditions imposed in an effort to restrain trade in unpatented articles[5].

In *Walker on Patents* (Deller's Ed.), Vol. II, page 1571, the interpretation is in accord with the headnote already quoted[6]. Ellis, in "Patent Assignments", Art. 361, under-

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[4] The issues, as stated by the court, were these:

"First, may a patentee or his license assignee license another to manufacture and sell a patented machine and by a mere notice attached to it limit its use by the purchaser or the purchaser's lessee, to films which are no part of the patented machine, and which are not patented?

"Second, may the assignee of a patent, which has licensed another to make and sell the machine covered by it, by a mere notice attached to such machine limit the use of it by a purchaser or by the purchaser's lessee to terms not stated on the notice but which are to be fixed, after sale, by such assignee at its discretion?"

[5] According to the headnote interpretation, this *Universal Film Co.* case means that a patent monopoly—

"is limited to the invention described in the terms of the patent, and that law does not empower the patent owner by notices attached to the things patented to extend the scope of the patent monopoly by restricting their use to materials necessary for their operation but forming no part of the patented invention".

The remaining questions, according to the headnote, related to issues of no concern here.

[6] Walker describes the case thus:

"The bill of complaint was for infringement of a patent on a projecting machine by reason of the violation of an alleged license restriction on the use of the machine purchased by the defendants, to be used only with films of the plaintiff. The Supreme Court held the restriction as to use invalid, as the film was no part of the patented invention, and was *an attempt to continue the patent monopoly of the film after patent thereon had expired.*" (Italics ours.)

stands the decision as not affecting the right of a licensor to govern the use to be made of his patent, so long as the use restrictions do not run counter to the principles laid down in the above decision[7].

## 2. In the Present Case there is no Attempt to Create a Monopoly by Contract, and Language in the Universal Film Case, therefore, Does Not Apply.

In the brief submitted by Brown's attorneys, in the case below, was a plausible analysis of the *Universal Film case* which may have been responsible for the decision rendered. Language was cited from the court, as quoted in the footnote below[8], which speaks of a distinction between rights which are given by the patent law, and those created by private contract.

That language, however, it should be noted, was used with respect to the use of contract in creating a monopoly *not* established by patent law, as contrasted with a *true* patent monopoly. It was used in connection with the facts

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[7] The text says:

"The *Dick* decision was overruled by the *Motion Picture* decision, 243 U. S. 502, but * * * it was overruled on grounds which did not affect the principle laid down in the *Dick* case, that the right to sell and the right to use were separable rights, and that exhaustion of the right to sell did not *ipso facto* make restrictions on subsequent use invalid. The restrictions to be valid must, however, not be contrary to the Clayton Act, or to the principles of public policy laid down in the *Motion Picture* decision."

[8] The language quoted was as follows:

"This decision proceeds upon the argument that, since the patentee may withhold his patent altogether from public use, he must logically and necessarily be permitted to impose any conditions which he chooses upon any use which he may allow of it. The defect in this thinking springs from the substituting of inference and argument for the language of the statute, and from failure to distinguish between the rights which are given to the inventor by the patent law and which he may assert against all the world through an infringement proceeding, and rights which he may create for himself by private contract, which, however, are subject to the rules of general, as distinguished from those of patent, law."

of that case. It has no application to covenants which lawfully limit the right of using the patent by a licensee—and do not even purport to create any other monopoly.

That the decision hinged on the attempted creation of monopoly, as an adjunct to a monopoly by patent law, seems really unquestionable. In the famous decision by Taft, Hammond and Lurton, JJ., in the *Button-Fastener* case[9], Lurton, J., said:

> "If we, for the present, assume the legality of the conditions and restrictions imposed on the purchasers * * * it is highly important * * * that we shall, at the outset, determine whether (use in violation of covenant is) infringement. * * * As to the *right to use the invention* (italics ours) he (the buyer) is obviously a mere licensee, having no interest in the monopoly granted by the letters patent" (p. 290).

Having reached that conclusion, the court then decided that the *kind* of condition was also lawful. And it was their decision on that point which the Supreme Court, in the *Universal Film case,* said was wrong; in that it upheld a restriction on the materials to be used, and thus had decided not to "debar (a patentee) from engrossing the market for an article not the subject of a patent". It was with respect to that part of Lurton's decision that the Supreme Court, in the *Universal Film* case, used the language[10], so effectively but improperly applied by Brown's attorneys in the case below.

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[9] *Heaton-Peninsular Button-Fastener Co.* v. *Eureka Specialty Co.*, 77 Fed. 288.

[10] See note 8, *supra.*

### 3. The Principle that Breach of Lawful Condition Constitutes Infringement is Accepted by the Circuit Court of Appeals of the Seventh Circuit; and this Creates a Conflict.

In *American Lacithin Co.* v. *Warfield Co.*[11], the United States Circuit Court of Appeals of the Seventh Circuit, referring to *Carbice Corp.* v. *American Patent Dev. Corp.*, 283 U. S. 27, said:

> "We believe that in the *Carbice* case the Supreme Court held that the patentee may not monopolize unpatented supplies. It is not our impression that the Supreme Court stated that the defendant in that case did not infringe the patent. The Supreme Court merely stated that such a patentee would not receive the aid of the courts * * *. We think that the Supreme Court warned him that, although 'Within his domain the patentee is czar', *Victor Talking Mach. Co.* v. *The Fair*, 7th Circuit, 123 Fed. 424, 426, any attempt to extend the patent monopoly would not be tolerated."

In the above case, defendants had apparently argued that plaintiff had forfeited its right of action on the patent by attempting to claim "contributory infringement" for actions which, under the *Carbice* case, created no cause of action. Answering that contention, the court termed it "wishful thinking"; then went on as quoted above to assert its belief that mere refusal to enforce a condition, for reasons of public policy, does not mean that breach of the condition is not infringement.

The facts were, of course, very different from the instant case. But the conflict of opinion is none the less real. The opinion expressed in the case above, had it been held in the Second Circuit, would have produced a result contrary to

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[11] 165 Fed. 2d, 207, 211.

the decision reached here; that seems too clear for question. Especially so, where that Seventh Circuit is the one wherein arose the *Indiana Mfg. Co.* v. *Shepard Co.* case.[12]

In the last mentioned case the court held, as your petitioner contends here, that a license is limited in its operation: and use of a patent "otherwise than in conformity with" lawful conditions therein is unauthorized and thus outside the protection otherwise afforded by the license; and the licensee thus becomes an infringer. The court then added:

> "It cannot be controlling whether or not the license uses the word 'condition'; and if that word is used, the exact and technical, grammatical construction of the sentence in which it is found will not settle the question whether it refers to a condition precedent or a condition subsequent."

On the contrary, said the court, citing the *Button-Fastener case*[13].

> "The principle seems to be that the license is limited in its operation, and that, since in the case of a territorial limit the license has no existence in the exempted territory, so in the case of other limitations the license has no existence in the exempted field."

That doctrine is still an active force in the Seventh Circuit, as we have just seen. Shorn of its tendency unlawfully to restrain trade in unpatented articles, this position is so logical and so old that it is unlikely to change or be modified unless the Supreme Court should so require. Conflict with the Second Circuit is thus deepseated and genuine—despite the unlike facts from which these divergent

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[12] 190 F. 579.

[13] 77 Fed. 294, 25 C. C. A. 267, 35 L. R. A. 728; also *Rupp & Wittzenfeld* v. *Elliott*, 131 Fed. 730, 65 C. C. A. 544.

views have most recently received a medium for expression. Under these circumstances it seems highly desirable for the Supreme Court to determine the rule one way or the other; for the country as a whole.

## Conclusion

In the foregoing argument your petitioner has proceeded on the assumption that a decision in the Circuit Court of Appeals may not disregard the property rights of a litigant, as determined by State law, merely because some more or less extraneous circumstance has brought the case before a federal court. Whether or not that can be done is of interest to multitudes of litigants other than your petitioner. And it is of vital interest to him; as would be true of others if the practice were allowed to continue unchecked by this Court. He now finds the fruits of his own process diverted to other hands, which selfishly claim also the right to discredit, injure and destroy the reserved rights he so dearly regained. This grossly inequitable conduct is possible only because the Circuit Court of Appeals ignored rights and remedies abundantly provided by state law.

Your petitioner has also relied heavily on the weight of public interest involved in maintaining order as among the several circuits, and conformity by Circuit Courts of Appeal with the law as it is from time to time determined by this Court. Not only is the Circuit Court of Appeals of the Second Circuit in basic conflict with the Seventh Circuit; but it appears to have given an unwarranted effect to a decision of this Court; an effect which distorts that decision and reads into it a meaning which is not to be found by the language in relation to its facts.

Moreover the Circuit Court of Appeals is in conflict with this Court itself in rejecting the use of local property law. It is in conflict with the Court of Appeals of New York in

applying to this controversy any except the local law. It is also in conflict with equitable decisions of various circuits, in giving equitable remedies to a petitioner in default.

If this court should sustain the petitioners' contention that the Circuit Court of Appeals relied on one or both of the errors assigned herein, your petitioners respectfully submit that an appropriate disposition of this case is to reverse the decision of the Circuit Court of Appeals, and remand the case to that court for a new hearing in which the evidence be evaluated in accordance with correct principles of law[1].

WILLIAM MORTON CARDEN,
Counsel.

On the Brief
JOSEPH E. GOODBAR

October, 1941.

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[1] *Grant* v. *Leach & Co.*, 280 U. S. 351.